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V I E W P O I N T

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Modest Progress, but Risks Remain

The Argus Economics Department has once again lowered its GDP estimates for 2H11, based on stubbornly high unemployment (which is curtailing consumer spending) and expectations of stable to lower government spending (given the finances of the U.S. Treasury as well as of states and municipalities). Our new forecasts for this period range from 1.5% to 2.3%, and average 1.9% — well below the "normal" U.S. GDP growth-rate trend of 3.0%.

Our current estimates do not call for a recession through 2012. We believe that there are enough positive signs among key economic indicators to keep the economy on a growth track. However, if the U.S. jobs base begins to contract, the odds of a recession will increase substantially.

2Q GDP Ticked Slightly Higher

The Commerce Department has released its final estimate of 2Q11 GDP growth, raising its estimate back to 1.3% from 1.0%. With this revision, the U.S. economy advanced at an average rate of 0.8% in the first two quarters of 2011 (please see GDP Table on Page 3).

While growth accelerated in 2Q from 1Q, the economy remains historically weak and has been in a challenging pattern since 2Q07. We frankly would not be surprised to see the government, in its next revision, declare the current period a recession.

Drivers of second-quarter growth, such as it was, were primarily in the Investment segment. For example, spending on Equipment & Software increased at a 6.3% rate. Low interest rates encouraged investment in Structures, which gained 22.6%. Even residential construction advanced 4.2%. And businesses added $39.1 billion to inventory levels.

The weak dollar also had an impact on the economy. A cheaper greenback gives a pricing advantage to U.S.-produced goods and services. During 2Q, U.S. exports of goods rose 2.5% and exports of services increased 6.2%. The cheaper dollar also makes imports more expensive. Last quarter, imports of goods and services increased just 1.4%. A year ago, when consumers were more ebullient, imports of goods and services rose 21.7%.

Speaking of the consumer, this segment remains the key determinant of the economy's direction. Consumers were cautious during 2Q as personal consumption advanced just 0.5%, the slowest pace since the recessionary second quarter of 2009. Spending on big-ticket durable goods, such as cars and washing machines, fell 5.3%.

Typically, when the consumer is down and out, the government will come in and pick up the slack. But not this time. Efforts by Republicans to focus the debate in Washington on the nation's deficit, rather than on jobs, paralyzed Congress and the Administration, and government spending fell 0.9%.

A weak consumer and a missing-in-action-government are two major negatives that the rest of the economy has not yet been able to overcome.

Looking Ahead: Trimming Again

Based on recent trends in consumer and government spending, we have trimmed our estimates for 3Q11 (see Chart 1). Previously, we had anticipated below-trend growth of 1.7% — but we are now expecting even slower growth of 1.5%. We expect the economy to pick up slightly in 4Q and 1H12, but even then we expect growth of just 2.3% at best.

Here are our key assumptions:

- We look for high unemployment to have a negative impact on Consumer Confidence and, more importantly,

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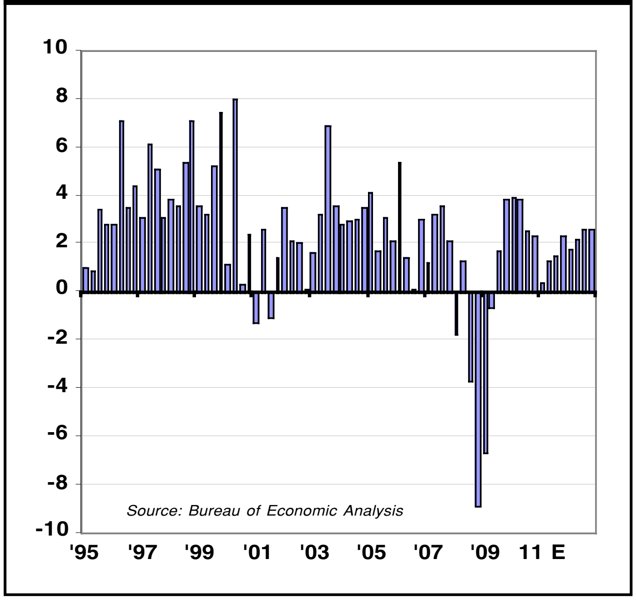
TABLE 1

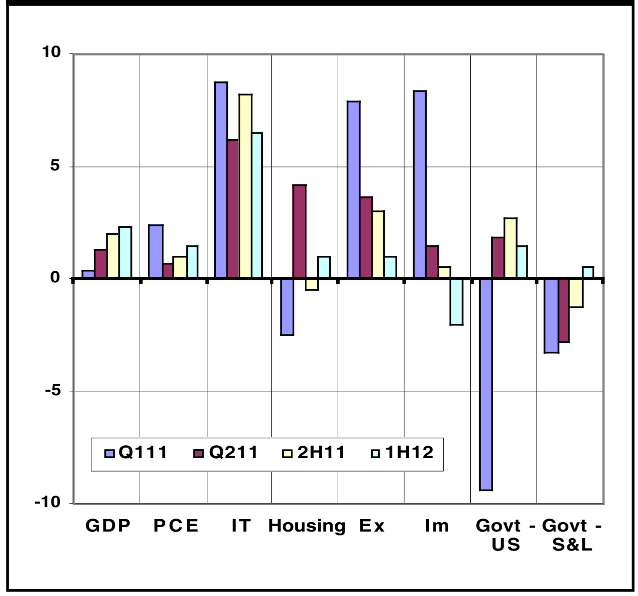
REAL GDP



We anticipate that a constrained consumer will keep U.S. economic growth well below the "normal" rate of 3.0% through 2012.

TABLE 2

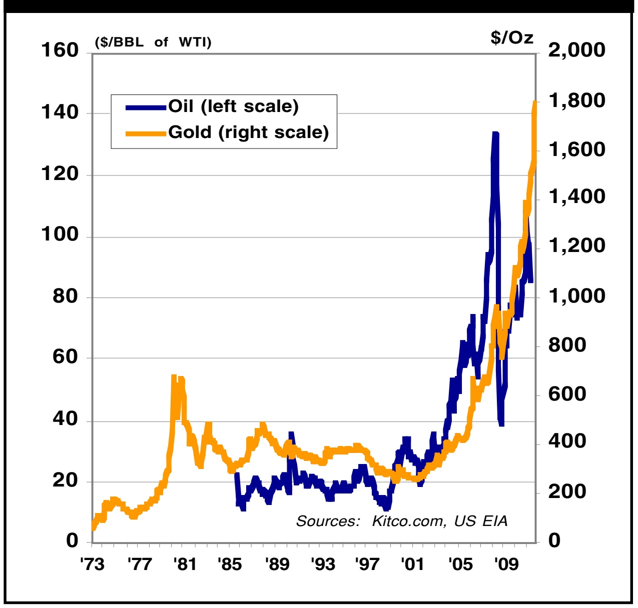
GDP GROWTH DRIVERS



Information Technology and Exports are expected to keep the economy growing.

TABLE 3

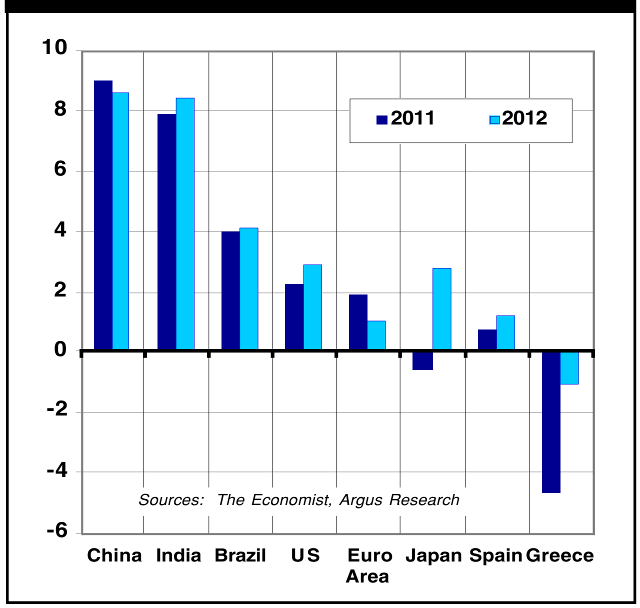
OIL & GOLD TRENDS



Falling oil prices should help the consumer economy.

TABLE 4

GLOBAL GDP FORECAST (RATES OF Y/Y GROWTH)



We look for global growth to remain steady for most trading partners, though Europe will likely lag as the Euro-nations work to resolve their sovereign-debt problems.

GDP FORECAST

Revised as of September 29, 2011

	2009 A				2010				2011 E				2012 E			
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Real Gross Domestic Product	-6.7	-0.7	1.7	3.8	3.9	3.8	2.5	2.3	0.4	1.3	1.5	2.3	1.8	2.2	2.6	2.6
Annual:				-0.5				3.1				1.4				2.3
Personal Consumption	0.6	-0.9	2.2	1.9	1.9	2.8	2.8	3.9	2.4	0.5	0.4	1.4	2.4	0.8	1.1	1.1
Goods	2.5	-3.1	7.2	2.9	5.7	3.4	5.1	8.9	5.3	-1.9	-0.3	2.6	1.7	1.0	1.8	1.8
Durables	3.9	-5.6	20.4	0.4	8.8	7.8	8.8	17.2	11.8	-5.3	-1.3	5.1	1.4	0.9	3.1	3.1
Non-Durables	1.9	-1.9	0.0	5.6	4.2	1.9	3.0	4.3	1.6	0.2	0.4	1.2	1.9	1.0	1.0	1.0
Services	-0.3	0.2	0.8	1.0	0.1	2.5	1.6	1.3	0.8	1.9	0.7	0.8	2.7	0.7	0.7	0.7
Gross Domestic Investment	-50.5	-23.7	-7.0	66.1	29.1	26.8	9.0	-5.3	4.5	6.0	-0.3	5.5	3.8	9.0	6.6	5.4
Fixed Investment	-39.0	-12.5	-14.4	20.2	3.3	22.8	2.4	7.4	2.0	8.6	4.2	5.6	5.0	6.8	6.7	5.5
Non-Residential	-39.2	-9.6	-8.5	6.7	7.8	21.9	11.8	8.6	3.0	9.7	5.8	6.8	5.9	7.0	8.2	6.7
Structures	-43.6	-17.3	-18.4	-18.1	-17.8	7.4	4.2	10.6	-14.4	22.6	-5.8	2.3	6.2	6.3	0.0	6.2
Equip. & Software	-36.4	-4.9	1.5	19.0	20.4	23.2	14.2	8.0	8.7	6.3	9.4	8.1	5.8	7.1	10.7	6.8
Residential	-38.2	-23.2	18.9	3.7	-12.3	22.8	-27.7	2.5	-2.5	4.2	-2.4	0.4	1.2	6.3	0.0	0.0
Change in Pvt. Inventories ($BIL)	-113.9	-160.2	-139.2	-19.7	44.1	68.8	92.3	38.3	49.1	39.1	19.6	19.6	30.0	40.0	40.0	40.0
Net Exports																
Exports	-29.9	-4.1	8.4	-2.5	11.4	10.0	10.0	7.8	7.9	3.6	3.9	1.5	0.6	1.6	1.6	1.8
Goods	-36.9	-6.3	17.5	23.1	14.0	11.8	9.0	9.2	10.6	2.5	4.9	0.6	0.8	0.6	0.6	0.9
Services	-13.6	0.2	24.6	34.1	5.8	6.1	12.5	4.7	1.7	6.2	1.4	3.5	0.2	3.8	3.8	3.8
Imports	-36.4	-14.7	5.6	2.7	11.2	21.7	12.3	-2.3	8.3	1.4	2.9	-0.8	-0.9	-3.6	-3.6	-7.2
Goods	-41.0	-16.5	21.2	16.1	12.0	26.0	12.4	-0.5	9.6	1.5	2.4	-0.8	-0.7	-4.3	-4.3	-8.6
Services	-11.5	-7.5	25.1	20.6	7.8	3.2	11.6	-10.4	2.2	0.4	5.5	-0.8	-1.9	0.0	0.0	0.0
Gov't Purch.of Goods & Svcs.	-2.6	6.7	3.2	-1.3	-1.6	3.8	1.0	-2.8	-5.9	-0.9	-0.2	1.0	1.0	0.8	1.0	0.3
Federal	-4.3	11.4	7.9	0.1	1.8	8.8	3.1	-3.0	-9.4	1.9	4.4	1.0	1.0	1.9	2.2	0.7
National Defense	-5.1	14.0	8.4	-3.6	0.4	6.0	5.7	-5.9	-12.6	7.0	3.2	1.6	0.4	1.7	2.2	0.0
Non-Defense	-2.4	6.1	7.0	8.3	5.0	14.6	-1.8	3.0	-2.7	-7.6	6.8	-0.3	2.3	2.2	2.2	2.2
State & Local	-1.6	3.9	-0.6	-2.2	-3.8	0.4	-0.5	-2.7	-3.3	-2.8	-3.5	0.9	1.0	0.0	0.0	0.0
Addendum:																
GDP Price Deflator (implicit)	1.0	0.3	0.7	-0.3	1.1	1.6	1.6	1.9	1.8	2.0	2.1	2.1	1.8	2.0	2.0	2.0

(continued from page 1)

Personal Consumption Expenditures. This component of GPD accounts for almost 70% of the economy. Our estimates call for growth of 0.5%-1.5% through 2H11. Our jobs model forecasts that unemployment will remain in the 8.8-9.0% range through year-end, absent a new stimulus program.

- As companies continue to refrain from hiring, we anticipate that spending on Equipment & Software, which drives productivity, will grow at a 5%-8% rate (see Chart 2).

- A low sales-to-inventory ratio implies that companies will continue to invest in inventories, and that the Industrial sector will continue to grow. We anticipate that this will provide a boost to the economy in each of the next four quarters, though we are not modeling rapid growth in inventories.

- The $320 billion U.S. housing industry has been flat to higher in recent quarters, despite the headlines, and we expect stability (if not 1%-2% growth) into next year.

- A weak dollar – courtesy of the dismal financial condition of the U.S. government – should make U.S. goods, including commodities, more attractively priced in global markets (see Chart 3). We anticipate mid-single-digit growth on average in exports over the next three to four quarters, as foreign economies continue to grow (see Chart 4).

- Federal government spending rose at a 1.9% pace in 2Q, after having declined for the previous two quarters. Heading into an election year, we anticipate low-single-digit growth, despite the heated rhetoric from both parties about spending cuts.

- State & local government spending dropped 2.8% in 2Q, and has declined in seven of the past eight quarters. This is an important component of the economy – particularly in the early quarters after a recession – that has been and will likely remain missing in action.

Positive Signals

We see enough positive momentum in the U.S. economy to conclude that recession can be avoided. Here are some of the factors we are following:

- Federal Reserve activity. The Fed has announced that it will sell short-term paper and buy $400 billion in long-term Treasuries. Proceeds from mortgage-related securities will be reinvested in MBS, helping to keep mortgage rates low.

- Unemployment Claims. A year ago, claims averaged 453,000 per week and were rising. However, claims were recently below 400,000. While the current level of claims is still higher than we would like to see, we think it is consistent with jobs growth, on average, of 75,000-125,000 per month. The past two months have been below this average, and we look for a recovery in the fall.

- Gasoline Prices. Concerns over global economic growth have reduced the price per barrel of West Texas Intermediate crude from above $100 during the summer to below $80. Savings from fuel costs may well show up in holiday retail spending, which we expect to advance at a 2.5%-3.5% rate.

- Manufacturing Activity. The Philadelphia Fed scare of August failed to sweep the nation, and the overall ISM reading for September registered a modest gain – while also remaining above the all-important level of 50 that signals expansion. Without government spending as a backstop, the Industrial sector is being forced to do some heavy lifting, and for the most part is responding.

Risks of Recession

At the same time, of course, there are risks that our forecasts may be too optimistic.

While we don't normally pay too much attention to consumer confidence surveys – we prefer the hard data from the government on sales, or better yet the same-store sales figures from the companies themselves – the surveys of business leaders are important because it is businesses that have the ability to create jobs. If the economy's jobs base starts to shrink, the odds of a recession will become much higher.

The politicians in Washington are also a factor that could derail economic growth. The Congressional SuperCommittee of budget-cutters is due to get back to work in November, but we are concerned that their efforts may be poorly timed. Given an almost-no-growth economy, the focus should be on creating jobs in the near term, not on reducing spending growth 3-5 years down the road.

The ongoing debate in Washington also has additional implications for the economy. The recent S&P credit rating downgrade hasn't yet led to higher interest rates for the U.S. government or for most corporations. But the downgrade has sapped confidence from purchasing managers and consumers. This confidence will need to be restored to lift economic growth rates back to normal.